

Internal Revenue Service
memorandum

TL-N-4529-88

WCSABIN

date: JUN 17 1988

to: Deputy Regional Counsel (Tax Litigation), Southwest Region

from: -Director, Tax Litigation Division

subject: Effect of Taxpayer Modification of TEFRA Settlement Agreements

You have requested technical advice on the problem of taxpayers modifying settlement agreements (Forms 870-P and 870-S).

ISSUE

Are the settlement agreements here binding on the government, and, if so, what recourse is available?

CONCLUSION

The settlement agreements are not binding.

FACTS

We understand the facts to be as follows.

In the course of TEFRA audits of partnerships and S Corporations in your region, settlement offers have been routinely made by transmitting unexecuted Forms 870-P and 870-S to the relevant parties. These settlement documents include an "attached schedule" which consists of columns of numbers summarizing the proposed adjustments to income at the entity level. You have discovered that you have received several of these settlement documents, executed by the taxpayers, with attached schedules different from the ones you had originally forwarded to the taxpayers. You executed these settlement documents because you erroneously believed them to be exactly the same documents you had forwarded to the taxpayers. Naturally, the taxpayers' altered version of the attached schedule contains different columns of numbers that result in little or no tax liability to the taxpayers. Since the cases have not been docketed, no documents have been filed with the Tax Court.

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You have also received information from an informant that the taxpayers and others deliberately conspired to make these alterations and to mail the settlement agreements to the Service Center, instead of the Appeals Officer, as had been requested, knowing that it was likely that the alterations would be overlooked.

-When you discovered the alterations you mailed letters to the taxpayers stating that, under the circumstances, you did not believe the settlement agreements to be binding.

DISCUSSION

The statute provides that TEFRA settlement agreements are binding unless there is a "showing of fraud, malfeasance or misrepresentation of facts." I.R.C. § 6224 (c). We believe that the facts we have would support an argument of either fraud or malfeasance here.

No cases have construed this section yet, and the regulations provide little guidance. Proposed Reg. § 301.6224(c)-1(a) appears to be concerned with the binding effect of a settlement agreement upon other partners, and does not contemplate the question of when such an agreement will not be binding on the government. Consequently a resort must be made to analogous case law.

Section 6224(c) roughly accords with the body of case law which has developed in the Tax Court regarding the right to modify a regular settlement agreement which has been filed with the Tax Court. The most recent case, Stamm v. Commissioner, 90 T.C. No. 25 (1988) did not set a precise standard, but noted that a unilateral error by respondent's counsel as to a settlement agreement, without a misrepresentation, by petitioner, was insufficient to modify the agreement.

Prior cases in the Tax Court are somewhat broader, in that they apply equitable principles and contract law to this area. In Saigh v. Commissioner 26 T.C. 171 (1956) the Court stated:

The law is well established that a court has some power to set aside a settlement stipulation filed with it but its discretion will not be exercised unless good cause is shown. A stipulation could be rendered inequitable by the development of a new situation . . . Id. at 176.

...
"Excusable damaging reliance upon a false or untrue representation of the other party, even one innocently made, is a recognized ground for relief from a settlement stipulation. Id. at 180.

And in Robbins Tire and Rubber Co. v. Commissioner, 52 T.C. 420, (1969) it said:

[A] compromise is a contract and thus is a proper subject of judicial interpretation as to its meaning in the light of the language used and the circumstances surrounding its execution. Id. at 435-436.

In none of these cases, however, did the Tax Court allow alteration of the subject agreements. See also Adams v. Commissioner, 85 T.C. 359 (1985); Spector v. Commissioner 42 T.C. 110 (1964); Brink v. Commissioner, 39 T.C. 602 (1962), aff'd, 328 F. 2d 622 (6th Cir., 1964); Cole v. Commissioner, 30 T.C. 665 (1958); and Himmelwright v. Commissioner T.C. Memo 1988-114, Cf. Williams v. International Association of Machinists and Aerospace Workers, 484 F. Supp. 917 (D.C. Fla. 1978), aff'd, 617 F.2d 441, cert. denied, 449 U.S. 840 (1980) (A settlement agreement cannot be rescinded, even for fraud, when it is not possible for the parties to return to their original positions).

It would appear then that the Tax Court would consider rescinding a decision document filed with it, if could be demonstrated that it had been obtained by the trickery of the petitioner. Here, however, the Tax Court has nothing to rescind because no decision document or anything else has been filed with it in connection with these cases.

Local law is applicable and helpful. The case of Stewart v. Mathes, 528 S.W. 2d 116 (Tex. Civ. App. 1975) held that contract principles apply to settlement agreements.

One Texas case held that parties to an arms length transaction are charged with the duty to read what they sign, and failure to do so constitutes negligence. Plains Cotton Co-Op Ass'n v. Wolf, 553 S.W. 2d 800 (Tex. Civ. App., 1977). Other cases have suggested that "fraud" or "trickery or artifice" constitute exceptions to that rule. See Reynolds - Penland Co. v. Hexter and Lobello 567 S.W. 2d 237 (Tex. Civ. App. 1978) and Farina v. Calvary Hill Cemetary, 566 S.W. 2d 650 (Tex. Civ. App. 1978). In each of these cases the aggrieved party had brought

suit to rescind a contract. They suggest that in the instant case, Texas law might consider these settlement agreements to be contracts subject to a suit for rescission.

This path, however, is fraught with complications. If we do assume that the agreements here are contracts, difficult questions arise. Must the government bring suit to rescind them? If so, should such a suit be brought in a federal or state court? If not, and the government merely repudiates them, is the government estopped from attacking them later? The answers are probably that the government should bring suit in a federal court, but will not be estopped from attacking their validity if it does not.

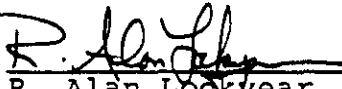
On the other hand there is a strong argument that these agreements are not contracts at all, or at least, not the sort to which the law of rescission applies. Even though the language on the Forms 870-P and 870-S, as well as that of § 6224(c), is similar to contract law terminology, we do not believe they are contracts. There are no real elements of bargaining, consideration or mutual exchange of promises here, or any of the hallmarks of a real contract. Instead, these are supposed to be agreements as to the Commissioner's determination of the "correct tax," See IRM 4015.2. Nobody in Examination has the authority to "settle" a tax dispute.

Therefore, we agree with the action you have taken in response to this problem. We recommend that your District reopen its audits of these entities, if it has not done so already. It is unlikely that the taxpayers will raise the question of whether these agreements are binding on the government because the government has put them on notice that it is aware of their malfeasance. If they do, the government will reply on the statutory exceptions - "fraud, malfeasance or misrepresentation" - which are incorporated in the text of these agreements.

However, we strongly recommend that your District preserve, and, if possible, develop the evidence it has that these alterations were the result of a concerted effort. Without such evidence, the taxpayers have a potentially successful argument that their replacement of the "attached schedule" with their own numbers was an innocent "counter-offer" which the government accepted.

If you have further questions please call Bill Sabin at FTS
566-3233.

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